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COUNTY OF SANTA CLARA

Report to the Finance and
Government Operations Committee

For the Fiscal Year Ended June 30, 2008

Mgt. Ltr.
5/11/09

COUNTY OF SANTA CLARA
Report to the Finance and Government Operations Committee
For the Fiscal Year Ended June 30, 2008

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Finance and Government Operations Committee
County of Santa Clara
San Jose, California

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate discretely presented component units and remaining fund information of the County of Santa Clara (the County) for the fiscal year ended June 30, 2008, in accordance with auditing standards generally accepted in the United States of America, we considered the County's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the County's internal control. Accordingly, we do not express an opinion on the effectiveness of the County's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. However, as discussed below, we identified deficiencies in internal control that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or a combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies listed as items 2008-A and 2008-B in the Schedule of Comments and Responses to be significant deficiencies in internal control. In addition, we noted other matters involving the internal control and its operation that we have reported to management as listed in the table of contents.

A material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the deficiencies listed as items 2008-A and 2008-B are not material weaknesses.

The County's written response to the findings identified in our audit is described in Schedule of Comments and Responses. We did not audit the County's responses and, accordingly, we express no opinion on them. In addition, we have already discussed our comments and recommendations with various County personnel, and we would be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing these recommendations.

In addition, we have included in this letter a report on communications with the Finance and Government Operations Committee (Committee) and the Board of Supervisors as required by auditing standards generally accepted in the United States of America.

The communication is intended solely for the information and use of the Finance and Government Operations Committee, Board of Supervisors, County management and others within the County and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & Cannel LLP
Certified Public Accountants

Walnut Creek, California
December 17, 2008

COUNTY OF SANTA CLARA
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REQUIRED COMMUNICATIONS

Professional auditing standards require auditors to communicate with the audit committee, or its equivalent, on a number of subjects. The following information satisfies these requirements, and is solely for use of the Finance and Government Operations Committee and County management.

I. The Auditor's Responsibility Under Auditing Standards Generally Accepted in the United States of America and OMB Circular A-133

As stated in our engagement letter dated April 8, 2008, our responsibility, as described by professional standards, is to express opinions about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting standards. Our audit of the financial statements does not relieve the County or management of their responsibilities.

In planning and performing our audit, we considered the County's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133.

As part of obtaining reasonable assurance about whether the County's financial statements are free of material misstatement, we performed tests of the County's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also, in accordance with OMB Circular A-133, we examined on a test basis, evidence about the County's compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement*, applicable to each of its major federal programs for the purpose of expressing an opinion on the County's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination of the County's compliance with those requirements.

II. Other Information in Documents Containing Audited Financial Statements

During the year, the County included audited financial statements in various debt offering documents (e.g., Official Statements). We do not have an obligation to perform any procedures to corroborate other information contained in such debt offering documents. We were not associated with and did not have any involvement with such documents. Accordingly, we did not perform any procedures on these documents and provide no assurance as to the other information contained in the debt offering documents.

III. Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to the County in our meeting about planning matters during August 2008.

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IV. Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our contract with the County, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the County are described in Note 1 to the County's basic financial statements. With the exception of the item described below, no new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2008.

As discussed in Note 1(o) to the County's basic financial statements, the County adopted Governmental Accounting Standards Board (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions* and GASB Statement No. 50, *Pension Disclosures – an amendment of GASB Statements No. 25 and 27*.

During fiscal year ended June 30, 2008, significant amounts of the Santa Clara County Financing Authority's variable rate lease revenue bonds were refunded as a result of market turmoil in the financial market for auction rate securities (ARS). The Santa Clara County Financing Authority refunded \$255.9 million in ARS with the issuance of Series 2008 L and Series 2008 M lease revenue bonds and \$126.4 million in ARS with the issuance of Series 2008 A as discussed in Note 8.

We noted no transactions entered into by the County during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Accounting estimates are an integral part of the financial statements prepared by management and are based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates are as follows:

- Fair value of investments
- Estimated valuation allowance for losses on accounts receivable
- Estimated valuation on donated capital assets
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property
- Estimated contractual adjustments and bad debt allowances for patient accounts receivable
- Cost report settlements receivable and payable
- Unasserted claims and loss contingencies
- Accrual and disclosure of self insured claims liabilities
- Accrual and disclosure of compensated absences
- Pension and other postemployment benefit plans' employer and employee contribution requirements
- Amortization estimates for net pension asset including amortization methods

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IV. Significant Audit Findings (Continued)

Management's judgments and estimates were based on the following:

- Fair values of investments were based on quoted market prices.
- Estimated valuation allowance for losses on accounts receivable were based on historical experience.
- Estimated valuation on donated capital assets were based on its estimated historical cost.
- Useful lives for depreciable property were determined by management based on the nature of the capital asset.
- Estimated contractual adjustments and cost report settlements receivable and payables were based on prior cost report adjustments, previous regulatory settlements, and the potential future retrospective adjustments based on current laws and regulations.
- Estimated bad debt allowances for patient accounts receivable were based on historical experience.
- The liability for automobile liability, general liability, medical malpractice, and workers' compensation claims were based on actuarial evaluations using historical loss and other data.
- The liability for other claims was determined by attorney judgment about the ultimate outcome of the claim.
- Accrual and disclosure of compensated absences were based on accrued eligible hours of vacation at current pay rates for eligible employees.
- Pension and other post employment benefit plans' employer and employee contribution requirements were based on actuarially determined contribution rates.
- Amortization estimates for net pension asset were based on actuarially determined factors.

During our audit, we evaluated the key factors and assumptions used to develop the estimates in determining that they are reasonable in relation to the financial statements taken as a whole.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. The attached schedule summarizes uncorrected misstatements of the financial statements. Management has determined that their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to the financial statements taken as a whole.

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IV. Significant Audit Findings (Continued)

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the basic financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated December 17, 2008.

Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the County's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Finding or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the County's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

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CURRENT YEAR COMMENTS

Significant Deficiency #1 – Item 2008-A

Coordination of the County's Accounting Standard Implementations

The Santa Clara County Central Fire Protection District (Central Fire), a component unit of the County, engages another audit firm to complete its audit. Central Fire has a separate defined benefit postemployment healthcare plan from the County. Based on our review of the Central Fire's stand alone audited financial statements, we noted that the Central Fire did not implement Governmental Accounting Standards Board (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, for the fiscal year ended June 30, 2008 along with the rest of the County. Although the County recorded its net other postemployment benefit obligations (OPEB) in accordance with GASB Statement No. 45 at June 30, 2008 for its employees covered by the defined benefit postemployment healthcare plan administered by the Employee Services Agency, the County under reported the Central Fire's OPEB by approximately \$12 million.

The County should work with Central Fire and all of their other auditors in coordinating the accounting standards to be implemented and presented in their stand alone financial statements at least annually so that these statements meet the County's comprehensive financial reporting requirements. In addition, the County should review the stand-alone draft financial reports to ascertain whether the information provided for consolidation into the County's Comprehensive Annual Financial Report is prepared in accordance with the required standards.

Management Response -

We concur with the recommendation, and will develop a checklist to help staff review the audit reports of all component units for compliance with GASB requirements. We will discuss all new reporting requirements with our external auditors at the 'Entrance Conference' held in May each year and also communicate those requirements to our component units and their independent auditors. The Controller-Treasurer Department routinely monitors all GASB pronouncements for any new accounting and reporting requirements or changes to the existing standards. We communicate those requirements to the departments and component units on a periodic basis. In addition, we provide training and information on major GASB pronouncements to departments and component units at our quarterly fiscal officers' meetings. Annually, we communicate the upcoming deadlines for new GASB requirements to independent auditors of all component units. The new checklist and annual discussion with external auditors will enhance our ability to ensure the component units' are coordinated with the County in its compliance with all GASB reporting requirements.

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Significant Deficiency #2 – Item 2008-B
Financial Reporting of Net Pension Asset

In May 2005, the State's Public Employees' Retirement System (PERS) agreed to restructure the County's pension contribution for the 2004-05 fiscal year-end and defer \$35 million of the scheduled payment. Since May 2005, interest in the amount of \$7.2 million has accumulated and was added to the liability. In fiscal year 2007-08, the County issued taxable pension funding bonds in order to refinance this obligation and to prepay other amounts arising from enhanced retirement benefits accruing to County employees totaling \$386.6 million.

During the fiscal year, the County did not reduce the deferred amount and cumulative accrued interest in the amount of \$42.2 million at June 30, 2008 against the prepayment of \$386.6 million, thereby overstating the County's net pension obligation and related net pension asset. This overstatement also caused the net pension asset amortization schedules to be incorrectly computed. As a result, an audit adjustment was recorded to reduce the County's obligation in the amount of \$42.2 million, reduce the net pension asset in the amount of \$29.7 million and increase net assets by \$12.5 million.

As the County enters into complex transactions, the Finance Agency staff should continue dialogue between affected parties (e.g., finance and benefits staff) and timely record these transactions in the accounting system to ensure accurate financing reporting.

Management Response -

We agree with the recommendation, and have already taken steps to improve communication among staff performing different aspects of certain complex financial transactions. For all future bond issuances, the debt administration staff will meet with the accounting and reporting staff to update on all pertinent financial aspects of the debt (issue or refunding) transaction upon completion of such transaction. This will ensure timely and accurate reporting of such transactions in the County's financial statements.

Other Comment #1 – Item 2008-C
Managing Investment's Interest Rate Risk

In accordance with Government Code Sections 53620-53622 and the County's investment policy, the Santa Clara County Retiree Healthcare Plan (Plan) investments, which are reported in an Internal Service Fund, may be invested in bonds that have a final maturity of 30 years or less from the purchase date and may have its fixed income holdings structured with sector concentrations comparable to those of the Lehman Aggregate Index. Additionally, the Board of Supervisors determined that up to 67% of the Retiree Healthcare Plan assets, excluding near-term liability payouts, may be invested in equities through mutual funds or through the direct purchase of common stocks by a money management firm(s) approved by the Board of Supervisors. In April 2008, the County approved an Other Postemployment Benefit (OPEB) funding plan using the Plan's investments to help fund the County's Annual Required Contribution (ARC) and projecting full utilization of the Plan's investments by fiscal year 2015. At June 30, 2008, 21% of the Plan's investments in fixed income securities had maturities in excess of 10 years and 46% of the Plan's investments were in equities through mutual funds. These investments' maturities do not match the timing of the County's planned use of funds. Investments with interest rates that are fixed for longer periods are likely to be subject to more variability in their fair values as a result of future changes in interest rates.

We recommend the County re-evaluate its current Santa Clara County Retiree Healthcare Plan investment policy and re-assess the fixed-income investment maturities limits and the permitted types of equities held in light of the County's planned shorter utilization period. In addition, the County should continuously evaluate its composition of its Plan's investments with its risk tolerance and expected Plan's investment usage.

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Other Comment #1 – Item 2008-C (Continued)

Management Response -

We do not believe that there is a need for the County to revise its investment policy for its Retiree Healthcare Plan as the policy is set in compliance with the California government code. We continually monitor the Retiree Health Fund's investment portfolio considering our timetable for full utilization of the Plan's investments by fiscal year 2015. Our staff routinely evaluates the portfolio for risk tolerance and expected usage. We do not believe that the County's intended investment objective for its Retiree Health Plan has changed significantly from the Board's decision to setup an OPEB plan, and to utilize the investments in its Retiree Health Fund by 2015. We believe that exiting the market at this time, liquidating all investments and converting to cash is not a prudent market timing strategy and could potentially cause a significant loss of equity. An immediate investment restructuring is not required as the intended objective of the plan assets has not materially changed. We will continue to routinely monitor the retiree health fund investments and periodically liquidate assets adequately to meet contribution requirements.

Other Comment #2 – Item 2008-D

Internal Control Monitoring

The County has a fiduciary responsibility as a steward of public funds. In order to fulfill this responsibility, the County has implemented internal controls that serve as the first line of defense in safeguarding assets. Additionally, these controls are designed to ensure: (1) effective and efficient operations, (2) reliable financial reporting and (3) compliance with applicable laws and regulations. The Committee on Sponsoring Organizations of the Treadway Commission (COSO) has established a nationally recognized framework for internal control in its *Internal Control – Integrated Framework* and its related *Guidance for Smaller Public Companies: Reporting on Internal Controls over Financial Reporting*. The COSO framework establishes five elements of internal control: (1) Control Environment; (2) Risk Assessment; (3) Control Activities; (4) Information and Communication; and (5) Monitoring. Risk Assessment and Monitoring are integral parts of internal control and management should periodically evaluate the risks and monitor the changes facing the County. This process involves evaluating both previously identified risks and potential new risks and providing assurance that (1) controls are designed properly to address significant risks and (2) controls are operating effectively.

During FY 2008, the County took an initial step to align its system of internal controls with the new auditing standards by reviewing and formally documenting the design of the County's significant internal control cycles in order to evaluate its design. We recommend the County continue its progress in evaluating the effectiveness of the internal control design by monitoring and testing the systems of internal controls in place.

Management Response -

We agree with the recommendation. The Controller-Treasurer Department is currently developing a plan that will include a detailed task list and estimated resources needed for this countywide project. We plan to lead a countywide effort in documenting and evaluating effectiveness of the County's systems of internal controls. The major effort will be to integrate internal control processes into a comprehensive mapping of cash receipts and cash disbursements cycles. The core documentation for controls will reside in a central repository with links to documentation that resides outside of the central repository. There will be clear accountability for updating the documentation of the internal control processes and ownership of the internal control processes themselves.

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STATUS OF PRIOR YEAR COMMENTS

Comment: FY 2007-A

Internal Controls Over Medi-Cal Reserve Analysis

Condition/Effect:

During our audit we noted that the SCVHHS's Medi-Cal reserve analysis included a calculation error caused by the unavailability of archived data resulting in an overstatement of the contractual allowances in the amount of \$9.6 million.

Recommendation:

We recommend the SCVHHS's Finance Department improve its archiving processes and related controls to ensure that work papers are readily available for use by them as well as the external auditors.

Status:

Corrected.

Comment: FY 2007-B

Review of the SCVHHS Enterprise Fund Financial Statements

Condition/Effect:

During our audit we noted that interfund transfers and investments earnings transactions and/or balances were recorded differently in the County's and SCVHHS's general ledger system.

Recommendation:

We recommend the SCVHHS's Finance Department provide a draft of the financial statements to the County's Controller Office for review prior to the submission to its external auditors to improve controls over the County's financial reporting process. In addition, the SCVHHS Finance should be permitted to adjust SAP summary balances up to the date its financial statements are provided to the County's General Accounting Unit.

Status:

Corrected.

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Comment: FY 2007-C

Trust Fund Determination

Condition/Effect:

During our audit we noted the following related to the County's trust fund determination:

- The County reversed its prior Criminal Justice trust fund determination and approved a one-time resource transfer in the amount of \$2.0 million from the Criminal Justice Fund to the General Fund for the operation and maintenance of the Criminal Justice Building.
- The County misclassified the Mental Health Proposition 63 fund as a trust fund instead of a governmental fund and subsequently recorded a \$14.2 million adjustment to recognize this revenue in the June 30, 2007 financial statements.

Recommendation:

We recommend the County periodically review its trust fund classifications in order to evaluate the propriety of inclusion or exclusion of the financial results with the General Fund.

Status:

Corrected.

Comment: FY 2007-D

Loans Receivable Analysis

Condition/Effect:

The financial reporting and accounting systems functions of the Office of Affordable Housing (Office) substantially rely on one individual to effectively perform necessary daily functions. During our audit, we noted that the Office had adjusted the loans receivable beginning balance in the amount of \$250,000 and was unable to timely complete and submit the detail loan schedule documenting this change to the Controller's Office. In addition, this loan change did not include an adequate review and approval.

Recommendation:

We recommend the Office evaluate appropriate staffing for the Office's functions and establish adequate review and approval processes. In addition, we recommend that the Office formally document its procedures related to the year-end analysis and financial reporting process to minimize the potential effects of "lost" knowledge due to unplanned turnover.

Status:

Corrected.

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Comment: FY 2007-E

Risk Assessment and Monitoring Over Financing Reporting

Condition/Effect

The County has a fiduciary responsibility as a steward of public funds. In order to fulfill this responsibility, the County has implemented internal controls that serve as the first line of defense in safeguarding assets. Additionally, these controls are designed to ensure: (1) effective and efficient operations, (2) reliable financial reporting and (3) compliance with applicable laws and regulations.

Recommendation:

We recommend that the County perform a comprehensive risk assessment analysis and document its risk assessment policies and procedures for each fiscal year.

Status:

In progress. See Comment FY 2008-D.

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SUMMARY OF UNCORRECTED FINANCIAL STATEMENTS MISSTATEMENTS

| PAJE # | Opinion Unit | Adjustment Description | Proposed Journal Entry | |
|--------|--|---|------------------------|---------------|
| | | | Debit | Credit |
| 1 | Government-Wide Governmental Activities | Expenses - Public Safety Net Other Postemployment Benefit Obligation <i>To record the estimated OPEB obligation for the Central Fire District at 2008.</i> | \$ 12,000,000 | \$ 12,000,000 |
| 2 | General Fund | Net Asset Revenue <i>To adjust the net asset balance due to prior year revenue accrual error.</i> | \$ 1,969,251 | \$ 1,969,251 |
| 3 | Government-Wide Governmental Activities | Capital grant and contributions - Recreation Net assets <i>To record land donation received by the County in prior years.</i> | \$ 5,000,000 | \$ 5,000,000 |
| 4 | Nonmajor Governmental Fund | Capital Outlay Accounts Payable <i>To record the capital project expenditures incurred during the current year.</i> | \$ 1,345,973 | \$ 1,345,973 |
| 4.1 | Government-Wide Governmental Activities | Nondepreciable capital assets Accounts Payable <i>To record additions to construction in process incurred during the current year.</i> | \$ 1,345,973 | \$ 1,345,973 |